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The trouble with GDP

Gross domestic product (GDP) is increasingly a poor measure of prosperity. It is not even a reliable gauge of production

ONE of Albert Einstein's greatest insights was that no matter how, where, when or by whom it is measured, the speed of light in a vacuum is constant. Measurements of light's price, though, are a different matter: they can tell completely different stories depending on when and how they are made.

In the mid 1990s William Nordhaus, an economist at Yale University, looked at two ways of measuring the price of light over the past two centuries. You could do it the way someone calculating GDP would do: by adding up the change over time in the prices of the things people bought to make light. On this basis, he reckoned, the price of light rose by a factor of between three and five between 1800 and 1992. But each innovation in lighting, from candles to tungsten light bulbs, was far more efficient than the last. If you measured the price of light in the way a cost-conscious physicist might, in cents per lumen-hour, it plummeted more than a hundredfold.

Mr Nordhaus intended this example to illuminate a general point about how flawed economists' attempts to measure changes in living standards are. Any true reckoning of real incomes must somehow account for the vast changes in the quality of things we consume, he wrote. In the case of light, a measurement of inflation

based on the cost of things that generated light and one based on a quality-adjusted measure of light itself would have differed by 3.6% a year.

When a first-year undergraduate first encounters the idea of GDP as the value added in an economy, adjusted for inflation, it sounds pretty straightforward, says Sir Charles Bean, the author of a recent review of economic statistics for the British government. Get into the details, though, and it is a highly complex construct—and, as Mr Nordhaus's fable shows, a snare for the unwary.

The production boundary

Measuring GDP requires adding up the value of what is produced, net of inputs, across a wide variety of business lines, weighting each according to its importance in the economy. Both the output and the materials (if any) used up in making it have to be adjusted for inflation to arrive at a figure that allows for comparison with what has gone before.

This is tricky enough to do for an economy of farms, production lines and mass markets—the setting in which GDP was first introduced. For today's rich economies, dominated by made-to-order services and increasingly geared to the quality of experience rather than the production of ever

more stuff, the trickiness is raised to a higher level. No wonder GDP statistics are still so prone to constant and substantial revision (see box on next page).

The problem is not just that it is hard to make these calculations. It is that what the calculations produce is a measure put to too many purposes, and, though useful, not truly fit for any of them. And there are worries that things may be getting worse. As the price of light illustrates, standard measures miss some of the improvements delivered by innovation. But at least new lighting products show up in the figures once people start buying the things in sufficient volume. These days it seems that a growing fraction of innovation is not measured at all. In a world where houses are Airbnb hotels and private cars are Uber taxis, where a free software upgrade renews old computers, and Facebook and YouTube bring hours of daily entertainment to hundreds of millions at no price at all, many suspect GDP is becoming an ever more misleading measure.

The modern conception of GDP was a creature of the interwar slump and the second world war. In 1932 America's Congress asked Simon Kuznets, a Russian-born economist, to estimate national income over the preceding four years. Until he produced his figures just over a year later, no

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one knew the full extent of the Depression. In Britain Colin Clark, an enterprising civil servant, had been collecting statistics on national income since the 1920s, and in 1940 John Maynard Keynes made a plea for more detailed figures on Britain's capacity to make guns, tanks and aeroplanes. He went on to establish the modern definition of GDP as the sum of private consumption and investment and government spending (with account taken for foreign trade). Kuznets had treated government spending as a cost to the private sector, but Keynes saw that if wartime procurement by the state was not treated as demand, GDP would fall even as the economy grew.

Keynes's idea of GDP won out on both sides of the Atlantic and soon spread further. Countries that wanted to receive post-war aid under America's Marshall plan had to produce an estimate of GDP. In the 1950s Richard Stone, a protégé of Keynes, was asked by the United Nations to prepare a template for GDP accounting that could be used by all member states. To be a nation was, in part, to know your GDP.

In wartime, GDP was concerned with managing supply. With peace, the influence of Keynes's ideas on fighting slumps flipped it into a way to manage demand, as Diane Coyle notes in her book, "GDP: A Brief but Affectionate History". Either way it was (and is) a measure of production, not of welfare—which, as GDP growth became a goal for politicians, also became an occasion for criticism.

A measure created when survival was at stake took little notice of things such as depreciation of assets, or pollution of the environment, let alone finer human accomplishments. In a famous speech in March 1968, Robert Kennedy took aim at what he saw as idolatrous respect for GDP, which measures advertising and jails but does not capture "the beauty of our poetry or the strength of our marriages".

It's a manufacturer's world

From time to time, such dissatisfactions have brought forth alternatives. In 1972 Mr Nordhaus and James Tobin, a colleague at Yale, came up with a "measure of economic welfare" which counted some bits of state spending, such as defence and education, not as output but as a cost to GDP. It also adjusted for wear-and-tear to capital and the "disamenities" of urban life, such as congestion. The paper was in part a response to environmentalist concerns that GDP treats the plunder of the planet as something that adds to income, rather than as a cost. It was much talked about; it was not much acted on. In 2009 a report commissioned by the French president, Nicolas Sarkozy, and chaired by Joseph Stiglitz, a prominent economist, called for an end to "GDP fetishism" in favour of a "dashboard" of measures to capture human welfare.

Kennedy was right. Much that is valu-

GDP revisions

Rewriting history

The nation's income is a constantly moving target

BY HOW much did Britain's economy grow in 1959? It would seem to be a question that ought to have been settled long ago. It hasn't been. Samuel Williamson of the University of Illinois finds that in the British government's annual "Blue Book" reports on GDP in the half-century or so since this uncelebrated year, there have been 18 different answers. The Blue Book published in 1960 said 2.7%; that of 2012 said 4.7%. British GDP, it seems, is under almost constant revision.

Britain is scarcely alone in rewriting recent history. Recent research by the OECD, a rich-country think-tank, found that for G7 countries the average absolute revision to GDP growth figures three years after preliminary estimates was at least as large as those seen in Britain. Those revisions tend always to increase the initial estimate—except in America, the only economy where initial estimates are usually too optimistic. Beyond three years, though, there is evidence that revisions in Britain are larger than its rich-country peers.

In poor countries, revisions can be huge. Nigeria's GDP was revised up by 89% in 2014. Later that year, Kenya's GDP

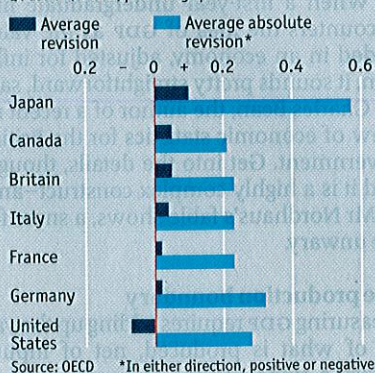
was revised up by 25%. Ghana's GDP had been upgraded by 60% in 2010.

Some of these bigger changes to GDP estimates are outcomes of "rebasings". GDP is measured by reference to a survey of the economy in a "base" year in which statisticians look at a sample of firms across business lines to gauge how quickly production is growing. The weight given to each industry depends on its importance to the economy in that year. As the economy changes over time, with some sectors growing faster than others, this snapshot becomes less accurate. Before its revisions in 2014, the base year for Nigeria's GDP had been 1990, providing a hopelessly outdated picture of the economy. The revised figures, based on 2010, gave due weight to industries, such as mobile telephony and filmmaking, that had sprung up in the meantime. In Kenya and Ghana, a delay in updating the base year meant their GDP figures had become similarly inaccurate.

To avoid periodic rebasing rich countries have switched to "chain-weighting", a system by which the base year is updated each year. Even so, new data or changes to the way GDP is calculated result in frequent revisions. There are a number of ways of calculating GDP—it can be treated as the sum of all value added, or the sum of all income or the sum of all expenditure—and they can be used to cross-check each other, but the data needed for the different methods do not become available at the same time. In Britain, early estimates of GDP rely on proxies for output, such as business turnover. As more information on spending and incomes from, for instance, tax returns is available, the cross-checking begins, which usually sees the figure revised upwards. Changes to the way GDP is estimated also typically lead to upward revisions; statisticians become better at tracking new industries or business models. There is, it seems, an upward drift to GDP measures over time.

Faulty first impressions

Revisions to quarterly GDP growth three years after preliminary estimate Q4 1994-Q4 2013, percentage points



able is neither tangible nor tradable. But much that is tradable is also not tangible. A problem with GDP even when it is being asked to do nothing more than measure production is that it is a relic of a period dominated by manufacturing. In the 1950s, manufacturing made up more than a third of British GDP. Today it makes up a tenth. But the output of factories is still measured much more closely than that of services. Manufacturing output is broken down into

24 separate industries in the national accounts; services, which now make up 80% of the economy, are subdivided into only just over twice that number of categories.

A bias toward manufacturing is not the only distortion. By convention GDP measures only output that is bought and sold. There are reasons for this, only some of them sound. First, market transactions are taxable and therefore of interest to the exchequer, an important consumer of GDP

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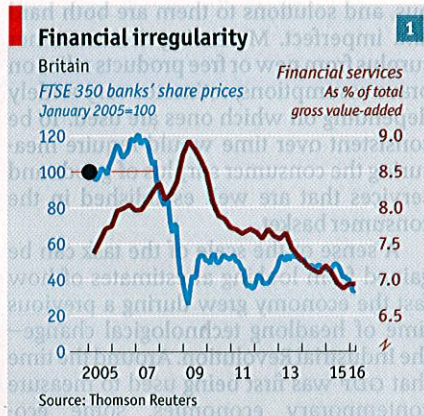
statistics. Second, they can be influenced by policies to manage aggregate demand. Third, where there are market prices, it is fairly straightforward to put a value on output. This convention means that so-called "home production", such as housework or caring for an elderly relative, is excluded from GDP, even though such unpaid services have considerable value. In early editions of his bestselling economics textbook Paul Samuelson joked that GDP falls when a man marries his maid.

Despite convention, a lot of what is included in GDP lies outside the market economy. Many government services are provided free, and for decades the value given to such output was simply the cost of provision. It is only fairly recently that statisticians have started to measure some bits of public-sector output directly by, for instance, counting the number of operations performed by health services or the number of students taught in schools.

Some private-sector services are also measured indirectly. Housing services is one. This is straightforward wherever householders rent the property they live in. Rental payments capture both the value of housing services to tenants as well as the income of landlords from providing them. But in places where most people own the home they live in, a large part of the total value of housing services has to be imputed.

Finance is another activity that is mostly measured obliquely (and badly). Typically financial services are not paid for directly in fees: banks make a large part of their income from charging more interest on loans than they pay on deposits. To capture the value being added, statisticians use an imputed figure, the "spread" between a risk-free interest rate and a lending rate, and multiply this by the stock of loans. The problem with this method is that the lending spread is a measure of the risk banks take. For this reason its use in GDP figures can have perverse results. For example, at the turn of 2009 Britain's financial sector was close to collapse. But because fear of bank defaults was driving spreads up, GDP figures recorded a spike in the sector's value added, and thus its contribution to GDP (see chart 1).

As statisticians try to capture ever more of the economy's output in their figures, new activities are added to GDP. In 2013 an EU agreement on GDP standards, for example, included income from selling recreational drugs and paid sex work. In Britain, the changes added 0.7% to GDP. How much credence should be given to that figure, though, is open to doubt. The statisticians have to fall back on crude proxies to estimate what is going on: thus the paid-sex market is assumed to expand in line with the male population, and the charges at lap-dancing clubs are taken as a measure of the price of sex. Leaving aside the appro-

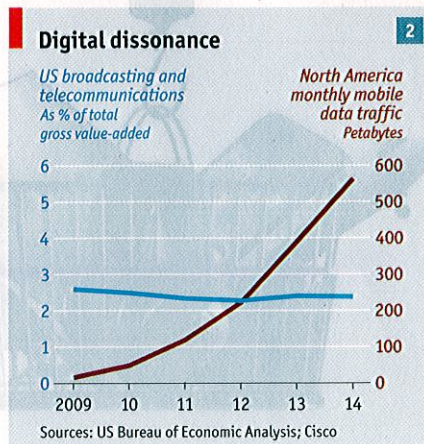


priateness of these approximations, Paul Samuelson might have been spurred to muse on the GDP implications of a woman marrying her gigolo. Robert Kennedy might have asked if a nation is really doing better when its sex- and drug-trades are growing more quickly.

The price is wrong

A further complication is that, for all the caution that statisticians offer against seeing GDP as a measure of welfare, the two are intertwined in perhaps the trickiest part of their calculations: adjusting for inflation. Inflation is a measure of how much more you have to pay this year than you did last year to achieve the same level of well-being. It is at least as challenging to measure as output.

For a start, a change in the price of a product will influence how much of it people buy. If red apples rise in price, people buy more green apples; if the price of beef shoots up, they buy more pork. There are tricks that capture this sort of substitution when compiling price measures. One is the "geometric-mean aggregation" of price quotes. Multiplying together the prices of *n* goods and then taking the *n*th root of the product allows price aggregations to take into account a degree of switching proportionate to the change in relative prices. This sounds abstruse: but getting it right has an effect of lowering inflation by half a per-



centage point or so. Broader shifts in consumer preferences are picked up by updating the weights attached to each category of goods in the overall price index.

Then come adjustments for changes in quality. This year's smartphone might cost more than last year's, but if so it will also do more. If statisticians focus only on changes in price, they will overstate the true inflation rate by missing improvements in performance. An advisory committee of leading economists set up by America's Senate in the mid-1990s and headed by Michael Boskin, of Stanford University, reckoned that failure to adjust for quality and new products meant true inflation was overstated by at least 0.6% a year. It called for greater use of "hedonic" estimation, a technique that captures the implicit value of each particular attribute of a product by measuring how variation in those traits affects the product's price: for example, how much more do people pay for a brighter light bulb? Once an implicit price for each attribute is established—processor speed, or memory, say, for a phone—prices are tweaked accordingly.

Hedonic estimation helps. But it is a labour-intensive business, because the implicit prices have to be updated frequently to ensure accuracy; in practice only a small fraction of prices are adjusted in this manner. It also runs into problems when quantitative changes get so large as to become qualitative. A modern flat-screen television is simply a different beast from the squat little cathode-ray tube numbers of the 1980s.

Such adjustments are even harder to do for services, which tend to be bespoke, than for goods, which are still for the most part standardised. The value of a meal, for instance, depends on the cooking and ingredients but also on the speed of service, the background noise, how close together the tables are, and so on. Each of these factors can change from one period to the next. The true value of public-sector services is even harder to measure comparably over time. The number of operations can be counted quarter by quarter. Their effects on health and longevity may not be seen for years or decades.

As the Boskin commission pointed out, new products are a particular headache. In theory their value to consumers is the gap between the reservation price (what consumers are willing to pay) and the actual price, known as "consumer surplus". In practice, new products enter the consumer-price index without any such adjustment. Then there is the sort of novelty that broadens choice. The number of TV channels or over-the-counter painkillers available in America, for instance, is overwhelming. Yet in 1970 there were just five of each. Though people may complain about too much choice, this greater variety is to a great extent a boon. But it is invisible

► to GDP measures. For GDP, the output of a million of shoes in one size and colour is the same as a million shoes in every size and colour.

The benefits of many new products are simply not picked up at all. The upfront costs of providing services on a digital platform, such as Facebook or Twitter, are hefty. But the marginal cost is close to zero, and the explicit price to users is normally nothing. By global convention, zero-priced goods are excluded from GDP. So are all voluntary forms of digital production, such as Wikipedia and open-source computer programs. Some of this unpaid-for activity can be picked up in the accounting; although there is no charge for a Google search, consumers pay a shadow price by supplying information and attention, for which advertisers pay. But the advertising revenue is likely to be well below the benefits that consumers get.

The review chaired by Sir Charles Bean outlined two other possible approaches to valuing free digital services. One is to estimate the value of the time spent on the internet. The Bureau of Economic Analysis, America's main statistical body, has used market wage rates to estimate the value of home-production activities, such as cooking, cleaning and ironing. Following a similar approach, Erik Brynjolfsson and Joo Hee Oh of MIT estimated that the welfare gain of free internet products added 0.74% a year to America's GDP between 2007 and 2011 (other studies reach somewhat lower estimates). The other approach uses rising internet traffic as a proxy (see chart 2 on previous page). The review cites research which found consumer internet traffic in western Europe growing at 35% a year from 2006 to 2014. If the output of IT services had grown at a similar clip, official GDP growth rates in Britain would have been 0.7 percentage points higher each year.

It is not just that many new services are now given away free; so are some that used to be paid for, such as long-distance phone calls. Some physical products have become digital services, the value of which is harder to track. It seems likely, for instance, that more recorded music is being listened to than ever before, but music-industry revenue has shrunk by a third from its peak. Consumers once bought newspapers and maps. They paid middlemen to book them holidays. Now they do much more themselves, an effort which doesn't show up in GDP. As commerce goes online, less is spent on bricks-and-mortar shops, which again means less GDP. Just as rebuilding after an earthquake (which boosts GDP) does not make people wealthier than they were before, building fewer shops does not make them poorer.

These problems do not invalidate the use of GDP. But given the direction of technological change in an ever-more digital world they seem likely to grow more seri-

ous, and solutions to them are both hard and imperfect. Measuring the consumer surplus from new or free products relies on brave assumptions; estimates vary widely depending on which ones are used. To be consistent over time would require measuring the consumer surplus of goods and services that are well established in the consumer basket.

A sense of the scale of the task can be gained from looking at estimates of how fast the economy grew during a previous time of headlong technological change—the Industrial Revolution. Around the time that GDP was first being used to measure contemporary economies, some economic historians ventured to apply it to the past, too. They concluded that there had been a sudden take-off in economic growth after 1750; a landmark post-war study reckoned that GDP per worker rose by 1.4% a year, an unprecedented rate, in the first half of the 19th century.

You say you measured a revolution

In the 1980s, research by Nicholas Crafts of Warwick University found that the 18th century's glut of industrially transformative inventions had been applied rather narrowly, with madcap growth seen only in a few sectors of the economy. He put productivity growth at a less revolutionary 0.5% a year. A generation further on colleagues of Mr Crafts, led by Steve Broadberry, published research which nudged the figures back up a bit. Even centuries on, it is hard to settle on GDP estimates in times of upheaval. And they still miss many of the changes wrought—the consumer surplus due to railways, say.

"It is a big mistake to think that one number serves for all purposes," says Sir Charles. The problem is that, as things

stand, GDP risks serving all its purposes ever-less well. The Bank of England has become so chary of GDP figures that it publishes a range of numbers both for its forecasts of growth and for its history. Its latest projections put recent GDP growth in Britain somewhere between zero and 4%. Such hyper-scepticism might seem a bit silly. But is it really no more absurd than proclaiming, with great certainty, that GDP growth in China fell from 6.8% to 6.7% in the year to the first quarter, when it almost certainly didn't?

If comparisons of GDP from one quarter to the next are dodgy, those from decade to decade are perilous. America's Census Bureau calculates that median household income, adjusted for inflation, was barely higher in 2014 than it was 25 years earlier. Measured living standards for a typical American have stagnated for a quarter-century, in other words. This finding undoubtedly reflects something real. But would a typical American really be indifferent between 1989 medical care at 1989 prices and today's medical services at current prices, asks Ken Rogoff of Harvard University? If GDP figures really measured what they try to measure, that would be the rational stance.

The challenge, said Mr Nordhaus in his paper on light, is to construct measures that "account for the vast changes in the quality and range of goods and services that we consume." But that means finding ways to more readily compare hand-held e-mail with fax machine, self-driving car with jalopy, vinyl records with music-streaming services and custom-made prosthesis with health-service crutches. Perhaps an Einstein could do it. Odds are, though, that he'd take one look and stick with the simplicities of physics instead. ■



Lexington | When economists turn to crime

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How cost-benefit analysis might save America's criminal-justice system



IT TOOK decades for politics—that messy, flawed business of gauging the public mood, haggling with interest groups and turning out votes—to build America's prison system: a behemoth of staggering size and cost, unlike anything else in the developed world. What chance is there that the monster can be tamed by the dry, abacus-clicking discipline of economics?

A non-trivial chance is the surprising answer, judging by a bipartisan conference of economists and policy wonks at the White House on April 25th, co-hosted by the conservative American Enterprise Institute and the broadly progressive Brennan Centre for Justice. The meeting launched a report into a system that, after decades of relentless growth, holds over 20% of the world's prisoners, though America is home to less than 5% of the global population. The report's dry title, "Economic Perspectives on Incarceration and the Criminal Justice System", should not deceive. Written by the White House Council of Economic Advisers (CEA), an in-house think-tank that has advised presidents since Harry Truman, it is a 79-page catalogue of unintended consequences, failed policies and heartbreaking waste, counted in the tens of billions of dollars and, more important, in human lives.

By tradition, American journalists refer to really startling facts as "Hey, Martha!" moments, imagining a newspaper reader exclaiming to a breakfast companion. In Britain, such facts are "marmalade droppers". Such moments fill the new report. America spends \$80 billion a year locking up 2.2m people, reflecting an incarceration rate that has climbed remorselessly to more than four times the world average, even as violent crime rates fell sharply. Between 1980 and 2014 the proportion of people behind bars more than tripled, with especially sharp rises among black and Hispanic men. Much growth was driven by "tough on crime" laws passed in the 1980s and 1990s, which sent even non-violent drug offenders to jail. If past trends continue, one in three black men born in 2001 can expect to serve time at some point.

Every year, 600,000 people are released from American prisons. More than half of all prisoners have mental health problems, while about two-thirds did not complete high school. Once out, ex-cons join about 70m Americans with criminal records, a status which in several states will deny them public housing and the right to vote, and legally bar them from occupations

which require a licence, such as hair-cutting or plumbing. Recidivism rates are dire: one study following people released from state prisons found that, within five years, more than half were back behind bars.

Small wonder that politicians on both the left and right are increasingly asking whether today's system is humane or just. Protesters have challenged the Democratic presidential hopeful, Hillary Clinton, to disown a crime law passed in 1994 by her husband, Bill Clinton, which included billions of dollars for new prisons and tougher sentencing rules. She has partially obliged, calling for an end to today's "era of mass incarceration". Congress is weighing bipartisan bills to loosen rigid sentencing laws. But for all the talk, politicians seem stuck. In Congress, conservatives vow to resist bills that might release violent offenders. Leftists demand radical change to a system they call inherently racist.

Enter the economists. The CEA report confines itself, explicitly, to questions of costs and benefits: whether locking so many people up for so long is an efficient way to reduce crime. Its conclusion is a resounding no. Incarceration does prevent some crimes from being committed, it concedes: a big California study from 2013 suggested that each extra year in jail typically avoided one or two property crimes, with the effects strongest for motor-vehicle theft. But hefty prison spells turn out to be a costly and clumsy way to deter offenders. Explaining this finding, the CEA's chairman, Jason Furman, cited the law of diminishing marginal benefits. Once a country's prison population is large, additional prisoners are more likely to be low-risk offenders. Indeed several studies suggest that harsher sentences may be counter-productive, for instance as young offenders emerge hardened by juvenile jails. Other research points to better policing and an ageing population as likelier causes of lower crime rates.

Misbehavioural economics

Two former directors of the Congressional Budget Office spoke at the White House meeting. Douglas Holtz-Eakin, a Republican who served on George W. Bush's CEA, called criminal-justice reform a "rare public-policy moment" that offers both parties a chance to save taxpayers money, help more people into the labour force, strengthen families and reduce poverty without sacrificing public safety. Peter Orszag, a Democrat who headed the Office of Management and Budget in Barack Obama's first term, called the evidence "compelling" that, to deter crime, the severity of a possible punishment matters much less than the certainty that it will be inflicted. Alas, politicians have poured resources into incarceration rather than more cost-effective tools, such as hiring more police and directing them to crime hotspots (America employs two-and-a-half times more corrections officers per person than the global average, but 30% fewer police). The vast majority of burglaries (85%) are never cleared up, while fewer than half of violent crimes lead to arrests.

One strength of this wonkish, follow-the-numbers approach is that it avoids the political challenge faced by reformers: the fact that many voters yearn to feel safe from crime, and do not want to be told that this is a wicked or selfish ambition. The CEA report duly calculates the cost to society from crime, and finds that it is large. But it then shows that today's policies are a horribly wasteful way of reducing that scourge. Scare-mongering headlines, followed by pandering and guesswork by politicians, have driven criminal-justice policy for too long. Enough marmalade-dropping panic: time to give cost-benefit analysis a go. ■

Free exchange | If it ain't broke, don't Brexit

The British economy would be neither destroyed nor unleashed by leaving the EU

ON JUNE 23rd Britons will vote on whether their country should stay in the European Union. They face a bewildering range of estimates of the potential economic effects of a Brexit. By 2030 Britain's GDP could be as little as a fraction of a percentage point below the level it would otherwise reach, or as much as 9.5 percentage points lower, depending on just whom you ask and what they assume about the future. While such analyses are useful (particularly in their clarifying agreement that Brexit would do at least some damage to the British economy over the next 15 years), they are also guilty of providing a spurious sense of precision. When attempting to predict the fate of the British economy after Brexit, it is useful to keep two rules of thumb in mind.

The first broad principle should hearten the Brexiters: over long periods, GDP per person in Britain has risen surprisingly steadily (see top chart). It has usually taken a war to cause that growth to deviate much from the underlying trend—although there was a long and painful slowdown during the 1920s and early 1930s, when Britain stuck doggedly to a contractionary monetary policy. As soon as Britain abandoned the gold standard in 1931, it was off again on a long streak of steady growth (briefly interrupted by the disruptions of the second world war).

Indeed, stable growth in output per person continued until the financial crisis of 2007-08. Joining the EU in 1973 does not seem to have accelerated it much, just as crashing out of Europe's system of pegged exchange rates in 1992 did not slow it down. Other seminal events—the loss of Britain's empire in the post-war years, or its balance-of-payments crisis and IMF bail-out in 1976—also seem to have had no impact on the trend.

Past performance is no guarantee of future returns, but Britain's history suggests that the costs of Brexit will probably not be as large or as lasting as the more dire prognostications maintain. As the Remain campaign often points out, membership of the European Union has not prevented Britain being one of the most

flexible, and least regulation-bound economies in the rich world. That flexibility would help Britain adjust to the shock of Brexit, as would the demand-boosting drop in the pound that would almost certainly follow a vote to leave.

However, a modest cost is still a cost. Moreover, whether a member of the EU or not, Britain is a European country, deeply and irrevocably linked to the fortunes of the continent. As annoying as it must be to the Leave campaign, only 21 miles (33km) of the English Channel separate Britain from France (and there is no distance at all between Northern Ireland and the Republic of Ireland, or Gibraltar and Spain). From Paris, Brussels and Amsterdam, it is a far shorter train journey to London than to Berlin. Britain is thoroughly, helplessly European, and always has been, since its first prehistoric settlers blundered over the land-bridge from the continent.

The European connection has big implications. Trade with far-off countries is costly, in terms of money and time. A paper published in 2012 by David Hummels of Purdue University and Georg Schaur of the University of Tennessee finds that every day goods are in transit adds a cost equivalent to a tariff of between 0.6% and 2.1%. Countries therefore trade most heavily with close neighbours. More than 50 years ago Jan Tinbergen, a Dutch economist, observed that trade seemed to follow a "gravity model", meaning that trade flows were a function of both the distance between trading partners and their size (or economic "mass").

Britain sits cheek-by-jowl with big European economies. They were Britain's dominant trading partners three centuries ago, when Europe accounted for 75% of British trade. And they are Britain's dominant trading partners now, accounting for roughly 50% of its trade, despite the fact that the rest of the world accounts for a much bigger share of global economic activity now than it did in the 18th century (see bottom chart).

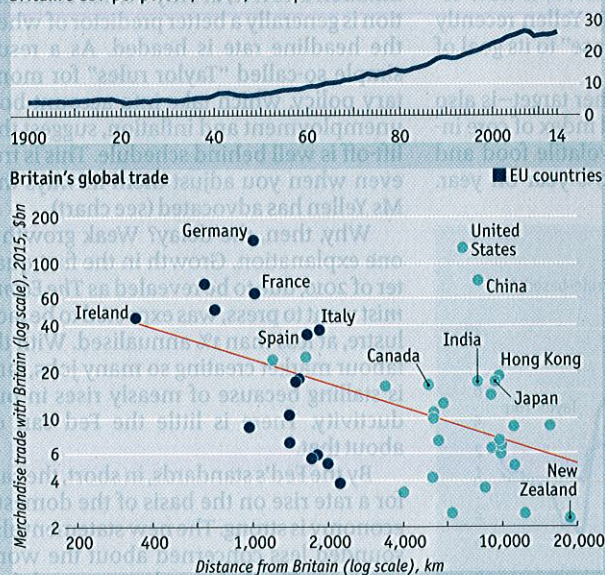
In fact, trade between Britain and the rest of the EU is larger than geography alone would predict, according to a recent analysis by the Centre for European Reform, a think-tank. It calculates that the flow of goods and services across the Channel is 55% greater than distance and economic mass alone would imply. What is more, that extra activity is a genuine bonus. It is almost entirely made up of new economic activity that would not otherwise take place, rather than exchanges diverted from partners outside the EU by the single market's external tariff. The integration fostered by European institutions nurtures cross-border supply chains and trade in services—a British speciality. Britain's exports of services to the EU are larger than those to North America, Japan and the BRICS combined. The EU, in effect, shrinks the distance between European economies even further.

Tilting at geography

In other words, the push for Brexit is quixotic. However close the cultural affinities between Britain and its partners in the Anglosphere, the contribution of their trade to British output is much smaller than the EU's, as are the contributions of the world's big emerging economies. A Brexit would not delink Britain's economy from the rest of Europe; it would merely worsen the terms on which trade is conducted and reduce Britain's influence in European affairs. History suggests that the choice to leave the EU would probably not prove a calamitous one in economic terms. That does not mean it would be astute. ■

Keep your friends close

Britain's GDP per person, £'000, 2011 prices



Sources: ONS; IMF; Bank of England

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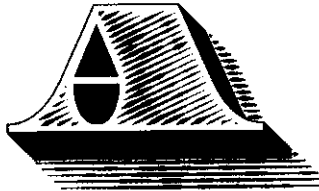
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Over the past four decades, the rules that govern the United States' free-market system have been warped. That, **Rana Foroohar** argues in her new book, *Makers and Takers*, seriously imperils every American's economic future. How we got here and how to fix it:

CAPITALISM



DEAR



COUPLE OF WEEKS ago, a poll conducted by the Harvard Institute of Politics found something startling: only 19% of Americans ages 18 to 29

identified themselves as "capitalists." In the richest and most market-oriented country in the world, only 42% of that group said they "supported capitalism." The numbers were higher among older people; still, only 26% considered themselves capitalists. A little over half supported the system as a whole.

This represents more than just millennials not minding the label "socialist" or disaffected middle-aged Americans tiring of an anemic recovery. This is a majority of citizens being uncomfortable with the country's economic foundation—a system that over hundreds of years turned a fledgling society of farmers and prospectors into the most prosperous nation in human history. To be sure, polls measure feelings, not hard market data. But public sentiment reflects day-to-day economic reality. And the data (more on that later) shows Americans have plenty of concrete reasons to question their system.

This crisis of faith has had no more severe expression than the 2016 presidential campaign, which has turned on the questions of who, exactly, the system is working for and against, as well as why eight years and several trillions of dollars of stimulus on from the financial crisis, the economy is still growing so slowly. All the candidates have prescriptions: Sanders talks of breaking up big banks; Trump says hedge funders should pay higher taxes; Clinton wants to strengthen existing financial regulation. In Congress, Republican House Speaker Paul Ryan remains committed to less regulation.

All of them are missing the point. America's economic problems go far beyond rich bankers, too-big-to-fail financial institutions, hedge-fund billionaires, offshore tax avoidance or any particular outrage of the moment. In fact, each of these is symptomatic of a more nefarious condition that threatens, in equal measure, the very well-off and the very poor, the red and the blue. The U.S. system of market capitalism itself is broken. That problem, and what to do about it, is at the center of my book *Makers and Takers: The Rise of Finance and the Fall of American Business*, a three-year research and reporting effort from which this piece is adapted.

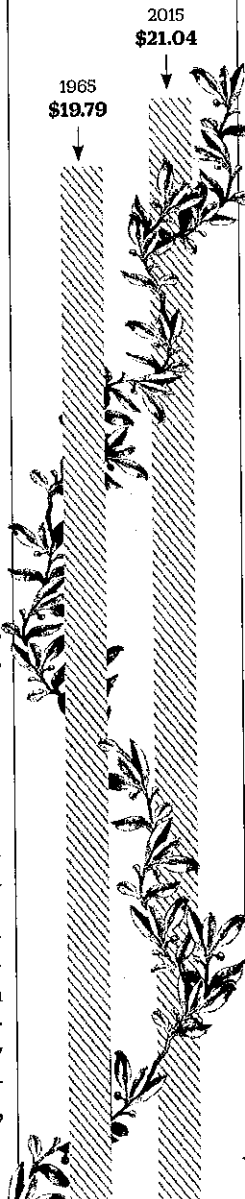
To understand how we got here, you have to understand the relationship between capital markets—meaning the financial system—and businesses. From the creation of a unified national bond and banking system in the U.S. in the late 1790s to the early 1970s, finance took individual and corporate savings and funneled them into productive enterprises,

STAGNANT INCOME

Financialization has funneled wealth up, not down, which is partly why middle-class wages have hardly budged since the 1960s

Wages

Average hourly pay has increased just \$1.25 in 50 years after adjusting for inflation



creating new jobs, new wealth and, ultimately, economic growth. Of course, there were plenty of blips along the way (most memorably the speculation leading up to the Great Depression, which was later curbed by regulation). But for the most part, finance—which today includes everything from banks and hedge funds to mutual funds, insurance firms, trading houses and such—essentially served business. It was a vital organ but not, for the most part, the central one.

Over the past few decades, finance has turned away from this traditional role. Academic research shows that only a fraction of all the money washing around the financial markets these days actually makes it to Main Street businesses. "The intermediation of household savings for productive investment in the business sector—the textbook description of the financial sector—constitutes only a minor share of the business of banking today," according to academics Oscar Jorda, Alan Taylor and Moritz Schularick, who've studied the issue in detail. By their estimates and others, around 15% of capital coming from financial institutions today is used to fund business investments, whereas it would have been the majority of what banks did earlier in the 20th century.

"The trend varies slightly country by country, but the broad direction is clear," says Adair Turner, a former British banking regulator and now chairman of the Institute for New Economic Thinking, a think tank backed by George Soros, among others. "Across all advanced economies, and the United States and the U.K. in particular, the role of the capital markets and the banking sector in funding new investment is decreasing." Most of the money in the system is being used for lending against existing assets such as housing, stocks and bonds.

To get a sense of the size of this shift, consider that the financial sector now represents around 7% of the U.S. economy, up from about 4% in 1980. Despite currently taking around 25% of all corporate profits, it creates a mere 4% of all jobs. Trouble is, research by numerous academics as well as institutions like the Bank for International Settlements and the International Monetary Fund shows that when finance gets that big, it starts to suck the economic air out of the room. In fact, finance starts having this adverse effect when it's only half the size that it currently is in the U.S. Thanks to these changes, our economy is gradually becoming "a zero-sum game between financial wealth holders and the rest of America," says former Goldman Sachs banker Wallace Turbeville, who runs a multiyear project on the rise of finance at the New York City-based nonprofit Demos.

It's not just an American problem, either. Most of the world's leading market economies are grappling with aspects of the same disease. Globally, free-market capitalism is coming under fire, as countries

PREVIOUS PAGES: ILLUSTRATION BY LON TWEETEN

SOURCE: BUREAU OF LABOR STATISTICS

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across Europe question its merits and emerging markets like Brazil, China and Singapore run their own forms of state-directed capitalism. An ideologically broad range of financiers and elite business managers—Warren Buffett, BlackRock’s Larry Fink, Vanguard’s John Bogle, McKinsey’s Dominic Barton, Allianz’s Mohamed El-Erian and others—have started to speak out publicly about the need for a new and more inclusive type of capitalism, one that also helps businesses make better long-term decisions rather than focusing only on the next quarter. The Pope has become a vocal critic of modern market capitalism, lambasting the “idolatry of money and the dictatorship of an impersonal economy” in which “man is reduced to one of his needs alone: consumption.”

During my 23 years in business and economic journalism, I’ve long wondered why our market system doesn’t serve companies, workers and consumers better than it does. For some time now, finance has been thought by most to be at the very top of the economic hierarchy, the most aspirational part of an advanced service economy that graduated from agriculture and manufacturing. But research shows just how the unintended consequences of this misguided belief have endangered the very system America has prided itself on exporting around the world.

AMERICA’S ECONOMIC ILLNESS has a name: financialization. It’s an academic term for the trend by which Wall Street and its methods have come to reign supreme in America, permeating not just the financial industry but also much of American business. It includes everything from the growth in size and scope of finance and financial activity in the economy; to the rise of debt-fueled speculation over productive lending; to the ascendancy of shareholder value as the sole model for corporate governance; to the proliferation of risky, selfish thinking in both the private and public sectors; to the increasing political power of financiers and the CEOs they enrich; to the way in which a “markets know best” ideology remains the status quo. Financialization is a big, unfriendly word with broad, disconcerting implications.

University of Michigan professor Gerald Davis, one of the pre-eminent scholars of the trend, likens financialization to a “Copernican revolution” in which business has reoriented its orbit around the financial sector. This revolution is often blamed on bankers. But it was facilitated by shifts in public policy, from both sides of the aisle, and crafted by the government leaders, policymakers and regulators entrusted with keeping markets operating smoothly. Greta Krippner, another University of Michigan scholar, who has written one of the most comprehensive books on financialization, believes this was the case when financialization began its fastest growth, in the decades from

MAIN STREET CREDIT CRUNCH

Commercial banks' interest in small-business lending has waned because it tends to be less profitable than other types of financial activity

Small-business loans

In 2015, 50% of small businesses had a financing shortfall, securing less than the full amount requested



As a result, 32% of growing firms reported that they had to delay expansion



and 21% turned to personal funds to finance their business

SOURCE: FEDERAL RESERVE SMALL BUSINESS CREDIT SURVEY



This article was adapted from Foroohar’s *Makers and Takers* (Crown), out this month

the late 1970s onward. According to Krippner, that shift encompasses Reagan-era deregulation, the unleashing of Wall Street and the rise of the so-called ownership society that promoted owning property and further tied individual health care and retirement to the stock market.

The changes were driven by the fact that in the 1970s, the growth that America had enjoyed following World War II began to slow. Rather than make tough decisions about how to bolster it (which would inevitably mean choosing among various interest groups), politicians decided to pass that responsibility to the financial markets. Little by little, the Depression-era regulation that had served America so well was rolled back, and finance grew to become the dominant force that it is today. The shifts were bipartisan, and to be fair they often seemed like good ideas at the time; but they also came with unintended consequences. The Carter-era deregulation of interest rates—something that was, in an echo of today’s overlapping left- and right-wing populism, supported by an assortment of odd political bedfellows from Ralph Nader to Walter Wriston, then head of Citibank—opened the door to a spate of financial “innovations” and a shift in bank function from lending to trading. Reaganomics famously led to a number of other economic policies that favored Wall Street. Clinton-era deregulation, which seemed a path out of the economic doldrums of the late 1980s, continued the trend. Loose monetary policy from the Alan Greenspan era onward created an environment in which easy money papered over underlying problems in the economy, so much so that it is now chronically dependent on near-zero interest rates to keep from falling back into recession.

THIS SICKNESS, not so much the product of venal interests as of a complex and long-term web of changes in government and private industry, now manifests itself in myriad ways: a housing market that is bifurcated and dependent on government life support, a retirement system that has left millions insecure in their old age, a tax code that favors debt over equity. Debt is the lifeblood of finance; with the rise of the securities-and-trading portion of the industry came a rise in debt of all kinds, public and private. That’s bad news, since a wide range of academic research shows that rising debt and credit levels stoke financial instability. And yet, as finance has captured a greater and greater piece of the national pie, it has, perversely, all but ensured that debt is indispensable to maintaining any growth at all in an advanced economy like the U.S., where 70% of output is consumer spending. Debt-fueled finance has become a saccharine substitute for the real thing, an addiction that just gets worse. (The amount of credit offered to American consumers

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has doubled in real dollars since the 1980s, as have the fees they pay to their banks.)

As the economist Raghuram Rajan, one of the most prescient seers of the 2008 financial crisis, argues, credit has become a palliative to address the deeper anxieties of downward mobility in the middle class. In his words, "let them eat credit" could well summarize the mantra of the go-go years before the economic meltdown. And things have only deteriorated since, with global debt levels \$57 trillion higher than they were in 2007.

The rise of finance has also distorted local economies. It's the reason rents are rising in some communities where unemployment is still high. America's housing market now favors cash buyers, since banks are still more interested in making profits by trading than by the traditional role of lending out our savings to people and businesses looking to make long-term investments (like buying a house), ensuring that younger people can't get on the housing ladder. One perverse result: Blackstone, a private-equity firm, is currently the largest single-family-home landlord in America, since it had the money to buy properties up cheap in bulk following the financial crisis. It's at the heart of retirement insecurity, since fees from actively managed mutual funds "are likely to confiscate as much as 65% or more of the wealth that... investors could otherwise easily earn," as Vanguard founder Bogle testified to Congress in 2014.

It's even the reason companies in industries from autos to airlines are trying to move into the business of finance themselves. American companies across every sector today earn five times the revenue from financial activities—investing, hedging, tax optimizing and offering financial services, for example—that they did before 1980. Traditional hedging by energy and transport firms, for example, has been overtaken by profit-boosting speculation in oil futures, a shift that actually undermines their core business

FEWER GOLDEN YEARS

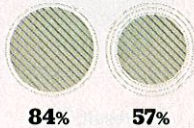
Americans are finding it harder to save enough money to retire; high asset-management fees can eat up retirement-fund gains

Retirement

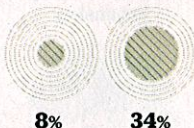
Today, workers 25 to 35 years old are planning to retire later than their counterparts two decades ago

1996 2016

65 or younger



Older than 65



Never retire



REMAINING PERCENTAGES DO NOT KNOW WHEN THEY WILL RETIRE

by creating more price volatility. Big tech companies have begun underwriting corporate bonds the way Goldman Sachs does. And top M.B.A. programs would likely encourage them to do just that; finance has become the center of all business education.

Washington, too, is so deeply tied to the ambassadors of the capital markets—six of the 10 biggest individual political donors this year are hedge-fund barons—that even well-meaning politicians and regulators don't see how deep the problems are. When I asked one former high-level Obama Administration Treasury official back in 2013 why more stakeholders aside from bankers hadn't been consulted about crafting the particulars of Dodd-Frank financial reform (93% of consultation on the Volcker Rule, for example, was taken with the financial industry itself), he said, "Who else should we have talked to?" The answer—to anybody not profoundly influenced by the way finance thinks—might have been the people banks are supposed to lend to, or the scholars who study the capital markets, or the civic leaders in communities decimated by the financial crisis.

OF COURSE, there are other elements to the story of America's slow-growth economy, including familiar trends from globalization to technology-related job destruction. These are clearly massive challenges in their own right. But the single biggest unexplored reason for long-term slower growth is that the financial system has stopped serving the real economy and now serves mainly itself. A lack of real fiscal action on the part of politicians forced the Fed to pump \$4.5 trillion in monetary stimulus into the economy after 2008. This shows just how broken the model is, since the central bank's best efforts have resulted in record stock prices (which enrich mainly the wealthiest 10% of the population that

SOURCE: EMPLOYEE BENEFIT RESEARCH INSTITUTE

How to rewrite the rules



The rules of capitalism are man-made. Here are five ways to begin righting the system

Make finance more transparent



"Too big to fail" is a problem, but so is "too big to manage." Financial institutions simply cannot become so complex that even their leaders can't track risk, as was the case leading up to 2008. That might necessitate breaking up some banks. But it also means more-transparent trading of derivatives and swaps, many of which are still too hard to track.

Stop rewarding debt over equity



America needs tax reform that ensures people and companies alike aren't rewarding hollow spending: buying McMansions, for instance, or using debt just to appease shareholders. Saving and investing—public and private, individual and corporate—should be incentivized by the national tax code.

Rethink who companies are run for



Shareholder value is a narrow definition of corporate value. Companies should be run for shareholders but also for workers, customers and, to a certain extent, society at large. Capital markets must serve the long-term growth of companies, not pressure them into short-term alchemy.

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owns more than 80% of all stocks) but also a lackluster 2% economy with almost no income growth.

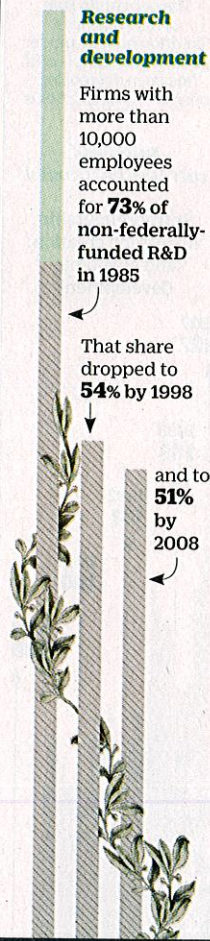
Now, as many top economists and investors predict an era of much lower asset-price returns over the next 30 years, America's ability to offer up even the appearance of growth—via financially oriented strategies like low interest rates, more and more consumer credit, tax-deferred debt financing for businesses, and asset bubbles that make people feel richer than we really are, until they burst—is at an end.

This pinch is particularly evident in the tumult many American businesses face. Lending to small business has fallen particularly sharply, as has the number of startup firms. In the early 1980s, new companies made up half of all U.S. businesses. For all the talk of Silicon Valley startups, the number of new firms as a share of all businesses has actually shrunk. From 1978 to 2012 it declined by 44%, a trend that numerous researchers and even many investors and businesspeople link to the financial industry's change in focus from lending to speculation. The wane in entrepreneurship means less economic vibrancy, given that new businesses are the nation's foremost source of job creation and GDP growth. Buffett summed it up in his folksy way: "You've now got a body of people who've decided they'd rather go to the casino than the restaurant" of capitalism.

In lobbying for short-term share-boosting management, finance is also largely responsible for the drastic cutback in research-and-development outlays in corporate America, investments that are seed corn for future prosperity. Take share buybacks, in which a company—usually with some fanfare—goes to the stock market to purchase its own shares, usually at the top of the market, and often as a way of artificially bolstering share prices in order to enrich investors and executives paid largely in stock options. Indeed, if you were to chart the rise in money spent

STIFLING INNOVATION

Large companies are more preoccupied with boosting share prices than funding R&D, which contributes to long-term company growth



SOURCE: NATIONAL BUREAU OF ECONOMIC RESEARCH

on share buybacks and the fall in corporate spending on productive investments like R&D, the two lines make a perfect X. The former has been going up since the 1980s, with S&P 500 firms now spending \$1 trillion a year on buybacks and dividends—equal to about 95% of their net earnings—rather than investing that money back into research, product development or anything that could contribute to long-term company growth. No sector has been immune, not even the ones we think of as the most innovative. Many tech firms, for example, spend far more on share-price boosting than on R&D as a whole. The markets penalize them when they don't. One case in point: back in March 2006, Microsoft announced major new technology investments, and its stock fell for two months. But in July of that same year, it embarked on \$20 billion worth of stock buying, and the share price promptly rose by 7%. This kind of twisted incentive for CEOs and corporate officers has only grown since.

As a result, business dynamism, which is at the root of economic growth, has suffered. The number of new initial public offerings (IPOs) is about a third of what it was 20 years ago. True, the dollar value of IPOs in 2014 was \$74.4 billion, up from \$47.1 billion in 1996. (The median IPO rose to \$96 million from \$30 million during the same period.) This may show investors want to make only the surest of bets, which is not necessarily the sign of a vibrant market. But there's another, more disturbing reason: firms simply don't want to go public, lest their work become dominated by playing by Wall Street's rules rather than creating real value.

An IPO—a mechanism that once meant raising capital to fund new investment—is likely today to mark not the beginning of a new company's greatness, but the end of it. According to a Stanford University study, innovation tails off by 40% at tech companies after they go public, often because of Wall Street pressure to keep jacking up the stock price, even if it means curbing the entrepreneurial verve that made the company hot in the first place.

A flat stock price can spell doom. It can get CEOs canned and turn companies into acquisition fodder, which often saps once innovative firms. Little wonder, then, that business optimism, as well as business creation, is lower than it was 30 years ago, or that wages are flat and inequality growing. Executives who receive as much as 82% of their compensation in stock naturally make shorter-term business decisions that might undermine growth in their companies even as they raise the value of their own options.

It's no accident that corporate stock buybacks, corporate pay and the wealth gap have risen concurrently over the past four decades. There are any number of studies that illustrate this type of intersection between financialization and inequality. One of the most striking was by economists James Galbraith

Build a national growth strategy



Politicians have been passing the buck for slow growth to the markets since the 1970s. Relying on Wall Street and central bankers to create artificial growth must be curtailed. This task falls to Congress and the next President. They must come up with sensible real fiscal policy and a growth plan to make the U.S. competitive on the global stage.

Redefine who's 'making and taking'



Finance is supposed to be a helpmeet to business, not the main event. The story of finance itself—as at the center of the American economy—must be altered to put businesses back in the driver's seat. The correct role for finance is to support job creators. Only that will ensure more robust national economic growth.

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and Travis Hale, who showed how during the late 1990s, changing income inequality tracked the go-go Nasdaq stock index to a remarkable degree.

Recently, this pattern has become evident at a number of well-known U.S. companies. Take Apple, one of the most successful over the past 50 years. Apple has around \$200 billion sitting in the bank, yet it has borrowed billions of dollars cheaply over the past several years, thanks to superlow interest rates (themselves a response to the financial crisis) to pay back investors in order to bolster its share price. Why borrow? In part because it's cheaper than repatriating cash and paying U.S. taxes. All the financial engineering helped boost the California firm's share price for a while. But it didn't stop activist investor Carl Icahn, who had manically advocated for borrowing and buybacks, from dumping the stock the minute revenue growth took a turn for the worse in late April.

It is perhaps the ultimate irony that large, rich companies like Apple are most involved with financial markets at times when they don't need any financing. Top-tier U.S. businesses have never enjoyed greater financial resources. They have a record \$2 trillion in cash on their balance sheets—enough money combined to make them the 10th largest economy in the world. Yet in the bizarre order that finance has created, they are also taking on record amounts of debt to buy back their own stock, creating what may be the next debt bubble to burst.

You and I, whether we recognize it or not, are also part of a dysfunctional ecosystem that fuels short-term thinking in business. The people who manage our retirement money—fund managers working for asset-management firms—are typically compensated for delivering returns over a year or less. That means they use their financial clout (which is really our financial clout in aggregate) to push companies to produce quick-hit results rather than execute long-term strategies. Sometimes pension funds even invest with the activists who are buying up the companies we might work for—and those same activists look for quick cost cuts and potentially demand layoffs.

IT'S A DEPRESSING STATE OF AFFAIRS, no doubt. Yet America faces an opportunity right now: a rare second chance to do the work of refocusing and right-sizing the financial sector that should have been done in the years immediately following the 2008 crisis. And there are bright spots on the horizon.

Despite the lobbying power of the financial industry and the vested interests both in Washington and on Wall Street, there's a growing push to put the financial system back in its rightful place, as a servant of business rather than its master. Surveys show that the majority of Americans would like to

STARTUP SLUMP

The per-capita rate of new business creation has not made substantial gains—and has been decreasing overall—since the 1980s

Startups (per 100,000 people)

Entrepreneurship fosters job creation and economic development



see the tax system reformed and the government take more direct action on job creation and poverty reduction, and address inequality in a meaningful way. Each candidate is crafting a message around this, which will keep the issue front and center through November.

The American public understands just how deeply and profoundly the economic order isn't working for the majority of people. The key to reforming the U.S. system is comprehending why it isn't working.

Remooring finance in the real economy isn't as simple as splitting up the biggest banks (although that would be a good start). It's about dismantling the hold of financial-oriented thinking in every corner of corporate America. It's about reforming business education, which is still permeated with academics who resist challenges to the gospel of efficient markets in the same way that medieval clergy dismissed scientific evidence that might challenge the existence of God. It's about changing a tax system that treats one-year investment gains the same as longer-term ones, and induces financial institutions to push overconsumption and speculation rather than healthy lending to small businesses and job creators. It's about rethinking retirement, crafting smarter housing policy and restraining a money culture filled with lobbyists who violate America's essential economic principles.

It's also about starting a bigger conversation about all this, with a broader group of stakeholders. The structure of American capital markets and whether or not they are serving business is a topic that has traditionally been the sole domain of "experts"—the financiers and policymakers who often have a self-interested perspective to push, and who do so in complicated language that keeps outsiders out of the debate. When it comes to finance, as with so many issues in a democratic society, complexity breeds exclusion.

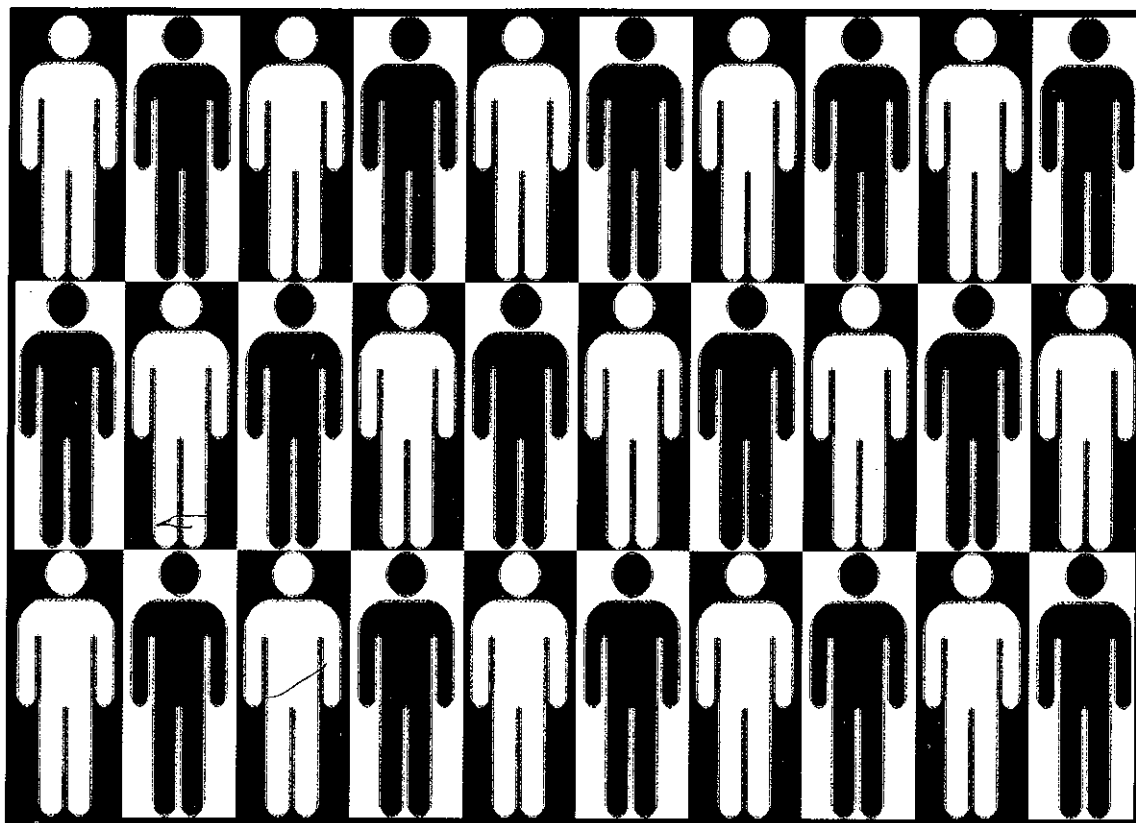
Finding solutions won't be easy. There are no silver bullets, and nobody really knows the perfect model for a high-functioning, advanced market system in the 21st century. But capitalism's legacy is too long, and the well-being of too many people is at stake, to do nothing in the face of our broken status quo. Neatly packaged technocratic tweaks cannot fix it. What is required now is lifesaving intervention.

Crises of faith like the one American capitalism is currently suffering can be a good thing if they lead to re-examination and reaffirmation of first principles. The right question here is in fact the simplest one: Are financial institutions doing things that provide a clear, measurable benefit to the real economy? Sadly, the answer at the moment is mostly no. But we can change things. Our system of market capitalism wasn't handed down, in perfect form, on stone tablets. We wrote the rules. We broke them. And we can fix them. □

SOURCE: CALCULATIONS BASED ON DATA FROM THE EWING MARION KAUFFMAN FOUNDATION

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It Pays to Be White



Assessing how White people benefit from race-based economic inequality.

BY JEANNETTE WICKS-LIM

BY EVERY MAJOR SOCIOECONOMIC MEASURE, THERE IS AN undeniable race-based hierarchy in the United States—with Black Americans sitting at or near the bottom. In 2014, the share of Black adults (at least 25 years old) with bachelor’s or advanced degrees (22%) is notably lower than their White counterparts (32%). The official unemployment rate for Black workers is persistently double that of White workers: in 2015, 9.7% vs. 4.3%. Also in 2015, the African-American poverty rate (26.2%) stood at more than double that among White Americans (10.1%). Black Americans account for 38% of the prison population, nearly three times their share of the U.S. population. White Americans, in contrast, account for 59% of U.S. prisoners, under-representing their 77% population share.

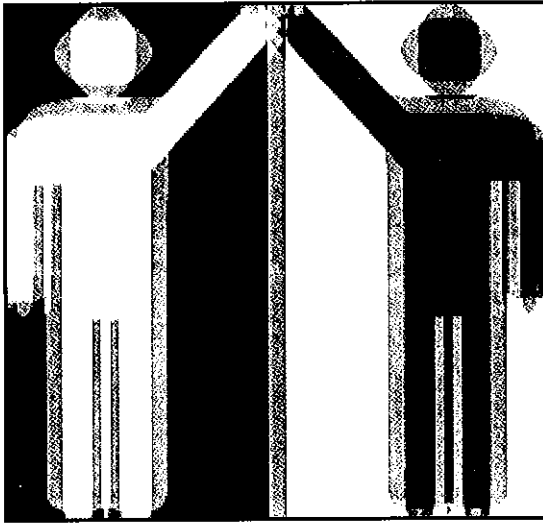
These lopsided outcomes have, of course, two sides: by every major socioeconomic measure, White Americans sit at or near the top of the race-based hierarchy. This is an obvious point. Here’s another one: if the economic odds are stacked against African Americans, the flipside is that White Americans have the odds stacked in their favor. We need to even these odds to achieve racial justice.

Current policy debates largely focus on reducing potential hurdles set in the way of African Americans. These same debates, however, overlook how race-based advantages put White Americans on an easier life path. To eliminate the United States’ race-based hierarchy, we need to redirect economic resources that currently operate as a premium for being White into creating equal opportunities for African Americans and other communities of color. Unfortunately, two policies specifically created to do so—affirmative action and reparations—only exist on the outer fringes of current policy debates.

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It Pays to Be White at School

According to a 2012 study, about one-third of the nation's students attend hyper-segregated schools: schools that are 90% White or 90% non-White. Students in the nearly all-White schools benefit from \$4,985 in local and state education spending per student (adjusted for regional differences in living costs), an \$810 premium over the \$4,176 spent on their counterparts in the nearly all-non-White schools. (All figures are inflation-adjusted to 2015 dollars.)



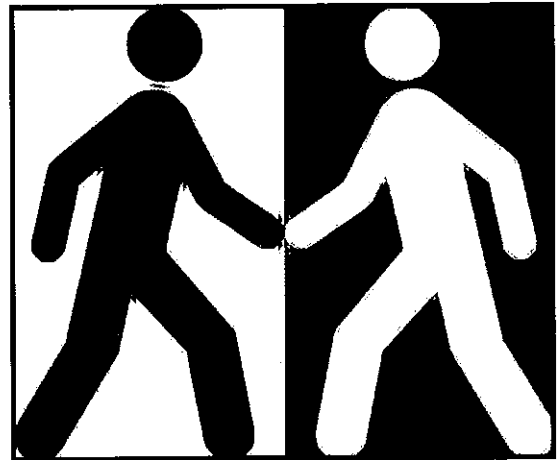
Over a 13-year K-12 public-school education, this White-school premium adds up to nearly \$10,000 more spending on each student in nearly all-White schools compared to students in nearly-all-non-White schools (\$810 premium x 13 years of schooling = \$10,530). This White advantage is even more impressive when pooled together under one school's roof. Given the average school size of 500 students, this White premium scales up to an extra \$2.8 million dollar investment into the elementary education in a nearly all-White school (\$810 per student x 500 students x 7 years of elementary education = \$2.8 million). This White-school premium can translate into White students learning in better physical facilities, having access to more curriculum offerings with more and higher-quality materials, and served by greater numbers of teachers and support staff.

It Pays to Be White on the Streets

City police departments' pro-active "stop and frisk" policing techniques have come under scrutiny in recent years. The term "stop and frisk"

refers to when a police officer stops and detains a person if the officer believes he or she has a reasonable suspicion that criminal activity is taking place. Controversy over "stop and frisk" policing is due to charges that officers apply the tactics unevenly—surveying and interrupting the daily routines of White Americans much less frequently than those of Black Americans.

Take, for example, the practices of the Boston Police Department (BPD). In 2010, the American Civil Liberties Union of Massachusetts and the BPD co-sponsored a study of the BPD's "Field Interrogating Observation Frisk and/or Search" (FIOS) practices. Researchers approved by both organizations examined the BPD's database of FIOS incidents from 2007–2010. The study, released in 2015, concluded that the BPD treated White neighborhoods more favorably—initiated fewer FIOS incidents, compared to Black neighborhoods, even after taking into account differences in neighborhood crime rates. In fact, the figures in the study indicate that White neighborhoods (defined here as 85% White) accumulated 2,500 fewer FIOS incidents annually compared to Boston neighborhoods with a high concentration of Black residents (85% Black).



This difference implies that if you're living in an 85% White neighborhood, chances are that you would be subject to police surveillance about once every decade. So, for example, by the age 30, such a resident might be surveyed, stopped and/or frisked twice: once at age 15 and then again at age 25. This resident's life is minimally disrupted by the BPD. If you're living in a Black neighborhood, chances are you'd have a FIOS incident every three years. In other words, by age 30, you can expect to have already had six unsolicited police encounters: at age 15, then at age 18, again at 21, again at 24, again at

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27, and again at 30 years old. The situation for Whites is even better than these numbers suggest. If you're White, the police are 11% more likely to only stop and ask you questions, not frisk or search you and your belongings compared to if you're Black. This difference in frisking rates of Whites versus Blacks is the same as the BPD's differential frisking rate of non-gang members versus gang members.

What's it worth to be White on Boston's streets? It's hard to put a price tag on the ability to move around freely.

It Pays to Be White at Work

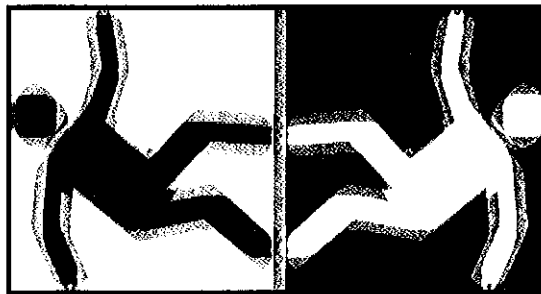
How much more do White workers benefit from paid employment than their Black counterparts? That is, what is the bonus for being White in the workplace? One way to get a handle on this is to calculate how much more the average White worker earns, over a working lifetime, compared to their Black counterpart. Note that in this exercise I do not "net out" differences in educational credentials, or any other type of possible measures of skill. This is in order to take account of how, for example, any White premium in schooling builds up into an additional White bonus at work in the form of job market preparation. In other words, the premium I calculate for being White at work includes the White bonus of better-funded educational opportunities, as well as increased access to better job opportunities, and higher rewards for work.



Take the situation of an average White male full-time worker and compare his experience in the labor force to his Black counterpart: In 2014, the average White male full-time worker earned \$10,900 more than his Black counterpart: \$44,900 vs. \$34,000. This average male White worker also has access to a paid job more consistently compared to his Black counterpart; the employment rate for White males is much higher than for Black males (95.7% vs.

90.3%). Their annual earnings equal \$42,900 and \$30,700, after accounting for their average unemployment spells. The gap is now \$12,200. At this rate, this White worker could work three months less per year, and still earn more money.

What does this mean over their entire work careers? To keep things simple, let's say each continues to work until the end of his or her life. Because White men live longer than Black men, this means that the average male White worker could potentially work from 25 to 77 years old, or 52 years. Black men die, on average, five years sooner at 72 years, for a work career of 47 years. Therefore, over an entire working career, White workers get a work bonus of \$790,000—\$2.2 million vs. \$1.4 million. It really does pay to be White at work.



It Pays to Be White When You Stumble

In 2011, the average White household held \$23,000 in liquid wealth, like deposits in a checking account or a retirement account. This is more than 100 times the average amount of \$200 held by African-American households. Considering all assets, including equity in a home, the average White American had more than ten times that of the average Black American, \$111,740 vs. \$7,113.

White people's access to wealth gives them a boost when they're down on their luck. Chances are much better that, if you're White, you can draw on some inherited asset or the assets of a family member when the proverbial chips are down. Hit with a large, unexpected medical bill? If you're White, your chances of managing this as just a bump in the road are much better than if you are Black.

Likewise, White people's greater access to wealth gives them a leg up when trying to get ahead. Starting a small business or trying to buy a house where there are good neighborhood schools? Trying to get a college degree without paying for tuition with your credit card? If you're White, your likelihood of being able to make that initial business investment, home down payment, or to cover that

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IT PAYS TO BE WHITE

college bill, is far better than if you're Black. These, of course, are key steps to anyone's larger effort to enter and stay in America's middle class—by improving one's own educational and employment prospects, as well as those of one's children.

White households' outsized share of wealth is deeply tied to the country's history of racist social institutions. Public policy has built up wealth for White citizens, at the expense of any social group considered non-White, for nearly the United States' entire history. Exemplars of such public policies include, of course, enslaving Africans and African Americans and expropriating land from Native Americans.

But public policies that build up wealth for White citizens, at the expense of other social groups extend through to more recent times. Take Pres. Franklin Delano Roosevelt's New Deal programs starting in the 1930s, such as the Home Owners' Loan Corporation (HOLC) and the Federal Housing Administration (FHA), or the 1944 Servicemen's Readjustment Act (GI Bill) that provided aid to World War II veterans. These programs intervened massively in the housing market by providing federally subsidized home mortgages. From 1935 to 1953, FHA and the Veteran's Administration backed, on average, 45% of the mortgages for new construction. This support, however, focused specifically on

subsidizing home ownership for Whites. White families benefited from the programs' use of restrictive covenants that required White homeowners to only sell to White buyers and from redlining that designated Black neighborhoods as undesirable areas for mortgage lending. These practices did not officially end until the 1968 passage of the Fair Housing Act. These policies effectively represented large-scale federal affirmative action programs for White Americans.

It Pays to Be White Nearly Everywhere

Growing evidence from the field of social psychology over roughly the past 20 years demonstrate how living and breathing in a world defined by an economic racial hierarchy appears to shape our most basic intuitions about the world—what is good or bad, what is dangerous or safe, what has value and what is valueless. This is the basic conclusion of social psychologists researching the phenomenon of implicit racial bias—a person's unconscious favorable or unfavorable action toward, or thoughts and feelings about, another person based on the person's race. Crucially, this bias occurs even in the absence of any consciously identified racial bias (see sidebar).

Implicit racial bias helps to make sense of what economists Marianne Bertrand and Sendhil Mullainathan observed in their 2004 study, "Are Emily and Greg More Employable than Lakisha and Jamal?" They found that the answer is: yes,

How to Detect Implicit Racial Bias

Social psychologists have come up with clever experimental designs to detect implicit racial bias. They do this with what's called an "Implicit Association Test" (IAT). To detect implicit racial bias, the IAT measures whether a person associates, without conscious deliberation, the concept or feeling of "good" with a White person compared to a Black person.

One version of this test has a participant sit in front of a computer. Words and names alternately appear on the screen. First, the person is instructed to hit the "I" key with their right hand to indicate if a word is "good" (e.g., "joy") and the "E" key with their left hand if the word is "bad" (e.g., "pain"). When a name appears on the screen, the person is instructed to hit the "I" key if the name is typically White ("Brad") and the "E" key if the name is typically Black ("Jamal"). This set-up associates "good" with "White"—the "I" key is hit for both, and "bad" with "Black"—the "E" key is hit for both. Then the exercise is repeated but with the association reversed: the participant is instructed to hit the "I" key if the name is typically Black ("Lakisha") and the "E" key if the name is typically White ("Allison"), while the words are sorted in the same way as before. Now, the set-up associates "good" with "Black" and "bad" with "White."

Researchers have found that people sort with greater ease when the key for Black and negative are the same, and the key for White and positive words are the same—evidence of an implicit racial bias. Studies using an IAT test like this one have found evidence of implicit racial bias regardless of whether participants express any type of explicit racial bias.

across a wide range of occupations and industries. For their study they sent out thousands of essentially identical resumes, with the exception of the name of the applicant. Those with stereotypically White names got callbacks for interviews 50% more frequently than resumes sent with stereotypically Black names.

Hard-pressed to find any economic rationale for this racial bias, the researchers speculate, "Employers receive so many resumes that they may use quick heuristics in reading these resumes. One such heuristic could be to simply read no further when they see an African American name." Moreover, the shock expressed by human resource managers over Bertrand and Mullainathan's findings suggests that this heuristic operates through an implicit—rather than explicit—racial bias. That is, employers don't consciously discard resumes with Black-sounding names. More likely, employers' hold an implicit racial bias that causes them, at a glance, to consider more favorably resumes with White-sounding names.

The social environment in the United States, steeped in race-based haves and have-nots, appears to train people's gut feelings to turn positive towards White people and negative towards Black people, unconsciously and automatically. As a result, it pays to be White nearly everywhere.

Policy Implications of White Privilege

All this leads to the conclusion that if African Americans have the deck stacked against them in every major life activity, White Americans have the deck stacked in their favor. Current policy debates need to focus on the question of how to eliminate White privilege. Two examples of public policies designed to do this include affirmative action and reparations.

The explicit goal of affirmative action policies is to increase the number of people of socially stigmatized groups into positions of prestige. Affirmative action is not just a policy about diversifying the classroom or the workplace. These types of policies aim to change the make-up of who holds high-ranking positions by decreasing the over-representation of members of advantaged groups.

Reparations, in the U.S. context, typically refers to a policy of providing compensation to descendants of Africans and African Americans who were enslaved in the United States. It can

also refer to compensation for the damage generated by any other systematically racist public policy. Whatever the form and amount of compensation, the basic aim of reparations is to use government funds to transfer wealth to African-American households in order to correct for past government practices that transferred wealth from Black households to White households.

Implicit racial bias, however, is a major pernicious obstacle to public policies aimed at correcting for White privilege. Implicit racial bias supports the existing racial hierarchy with a gut feeling that people get what they get because that's what they deserve—in particular, that White people tend to get more because they deserve more, while Black people get less because they deserve

If one begins with the premise that in the U.S. economy, African Americans have the deck stacked against them in every major life activity, the flipside is that White Americans have the deck stacked in their favor. Current policy debates need to focus on the question of how to eliminate White privilege.

less. This is one factor explaining the often-vitriolic political resistance to calls for reparations. Even affirmative action is currently treated as a policy debate non-starter.

Policies that require White people to give something valuable up—privileged access to a well-funded neighborhood school, an apartment or house, admission to a university, a high-paying or high-status job, a seat in Congress—become politically toxic when combined with implicit racial bias. This is the ultimate upside of race-based inequality for White Americans: it encourages White Americans to feel entitled to rebuke the policies that would end their White privilege.

What about tackling the issue of economic inequality more broadly? A flatter social hierarchy would, at minimum, limit the size of race-based gaps. Take for example, raising the federal minimum from today's \$7.25 to \$15.00. This policy would result in raises to 54% of Black workers

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and 59% of Latino workers compared to 38% of White workers.

At the same time, to uphold the moral integrity of such a political movement, and its potential broad-based political appeal, depends on coming honestly to the unifying call that “we’re all in this together.” This requires explicitly addressing the reality that yes, we’re all in this together, but even among the 99% some get—and feel entitled to—more than their fair share.

In other words, policies that address inequality more broadly must not be used as a way to sidestep the truth about the racial hierarchy that exists in the United States. To be sure, we need social policies that address inequality more generally to build a more just economy. The United States has about 20 million poor White Americans to show for that. Still, White people—up and down the economic scale—benefit from a race-based advantage that simply does not exist for African Americans.

Promoting race-based policies, such as affirmative action or reparations, does present a political risk: it could critically weaken class-based solidarity by exacerbating race-based tensions. Such racial division can thwart efforts to hold together the needed political coalitions to fight for a more broadly just economy. In a forceful critique against calls for reparations, Black American political scientist Adolph Reed states plainly that “there’s nothing (less) solidaristic than demanding a designer type policy that will redistribute only to one’s own group.”

At the same time, the continuing success of Donald Trump’s 2016 presidential bid (as of this writing) suggests that this view may be shortsighted. Trump’s racist innuendos—his “dog-whistle” politics—clearly tap into deeply felt, race-based resentments among White workers frustrated by their four-decades-long experience of economic stagnation. His stump speeches might not have such an electrifying appeal if this country ever had an honest reckoning of past and existing racist policies and practices—an honest reckoning that would reasonably call for policies such as affirmative action and reparations.

Such a reconciliation process may represent the best chance of removing Black Americans from the go-to list of scapegoats for why America is no

longer great, and must be made “great again,” to paraphrase Trump’s slogan. In the long run, challenging White privilege head-on may open the way to secure a cross-racial, class-based, political alliance resistant to cleaving under the pressure of economic hard times.

The sobering reality is that the odds that this type of reconciliation would lead to such a positive outcome, while greater than zero, are still slim, given the country’s long-standing history of racial division. However, it could very well be the only path to building a solidarity movement among the 99% resilient enough to address inequality more broadly. **D&S**

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SOURCES: Marianne Bertrand and Sendhil Mullainathan, “Are Emily and Greg More Employable than Lakisha and Jamal? A Field Experiment on Labor Market Discrimination,” *The American Economic Review*, September 2004; Carmen DeNavas-Walt and Bernadette D. Proctor, “Income and Poverty in the United States: 2014,” *Population Reports*, September 2015; Jeffrey Fagan, Anthony A. Braga, Rod K. Brunson, April Pattavina, “Final Report: An Analysis of Race and Ethnicity, Patterns in Boston Police Department Field Interrogation, Observation, Frisk, and/or Search Reports,” June 15, 2015; Federal Bureau of Prisons, March 26, 2016 (bop.gov); Leo Grebler, David M. Blank, and Louis Winnick, “The Role of Federal Aids in Mortgage Finance,” in Leo Grebler, David M. Blank, and Louis Winnick, eds., *Capital Formation in Residential Real Estate: Trends and Prospects* (Princeton University Press, 1956); Anthony G. Greenwald, Debbie E. McGhee, and Jordan L. K. Schwartz, “Measuring Individual Differences in Implicit Cognition: The Implicit Association Test,” *Journal of Personality and Social Psychology*, 1998; Anthony Greenwald and Mahzarin R. Banaji, “Implicit Social Cognition: Attitudes, Self-esteem, and Stereotypes,” *Journal of Personality and Social Psychology*, 1995; National Center for Education Statistics, “Numbers and Types of Public Elementary and Secondary Schools From the Common Core of Data: School Year 2009-10,” September 2012 (nces.ed.gov); Adolph Reed, Jr., “The Case Against Reparations,” *The Progressive*, December 2000; Ary Spatig-Amerikaner, “Unequal Education: Federal Loophole Enables Lower Spending on Students of Color,” Center for American Progress, August 2012; Rebecca Tippet, Avis Jones-DeWeever, May Rockey Moore, Darrick Hamilton, and William Darity, “Beyond Broke: Why Closing the Racial Wealth Gap is a Priority for National Economic Security,” Center for Global Policy Solutions, 2014; United States Bureau of Labor Statistics, “Labor Force Characteristics by Race and Ethnicity,” November 2015 (bls.gov); United States Census Bureau, “QuickFacts,” 2015 (census.gov); United States Census Bureau, “Educational Attainment in the United States: 2014,” 2015 (census.gov); Jeannette Wicks-Lim, “A \$15 Federal Minimum Wage: Who Would Benefit?” PERI Research Brief, March 2016; Jiaquan Xu, Sherry L. Murphy, Kenneth D. Kochanek and Brigham A. Bastian, “Deaths: Final Data for 2013,” Division of Vital Statistics, Feb. 16, 2016.